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I. CHINA: LEADERSHIP CONSENSUS WITH LATENT FISSURES (4/24)

Two years after Tiananmen split the Chinese leadership, there is greater consensus on domestic policy among top leaders than at any time since the early 1980s: virtually all support moderate, incremental reforms coupled with tight social and ideological controls. But a wide gulf in outlook divides the leaders from much of the bureaucracy, the public, intellectuals, and many provincial leaders.

Latent political fissures are likely to widen as central leaders prepare for 1992-93 party and government congresses set to rearrange the leadership line-up for new five-year terms. The political process will include searching for a consensus with provincial leaders who represent a wide range of opinion and interests. The death of one or more major leaders, domestic instability, or a major foreign policy challenge could set off new infighting, even before the new leadership sweepstakes.

Throughout the 1980s China's leadership contained a broad spectrum of opinion, from conservative ideologues to [REDACTED] reformers like former party chiefs Hu Yaobang and Zhao Ziyang. Now, after the purge of Zhao's group, the leadership consists mostly of technocrats who value economic, political, and social stability above all.

Consensus on economic reform . . .

Serious economic difficulties, and criticism of the austerity program implemented in late 1988, have forced current leaders to shift from retrenchment to a resumption of reforms aimed at addressing some of China's pressing problems. The leadership has three primary goals: reducing a mounting central budget deficit, addressing economic structural inefficiencies, and ameliorating public dissatisfaction with inadequate housing and social-welfare benefits. Measures adopted are widely seen as necessary first steps to more fundamental economic reforms.

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. . . and political control

Leaders also appear united in their determination to maintain strict social and political controls to prevent another challenge to the regime, a reflection of political conservatism and of an awareness of the gulf between leaders and led since Tiananmen.

Since June 1989 repression has waxed and waned; it seems to be building again. In recent weeks security officials have said they were still looking for dissidents and that arrest warrants for those who fled overseas remain in force. Surveillance and entrapment efforts are still under way to collect evidence with which to charge Zhao's political associates, and a new purge of reformers reportedly has begun in the media and parts of the party bureaucracy. Clampdowns have been renewed in religious and cultural circles, and even some economists--usually given greater freedom--are saying that with completion of the five-year plan they are facing tougher restrictions on speaking and publishing.

Infighting in abeyance

Routine jockeying aside, the current leadership seems to have worked out a modus vivendi. But latent rivalries are likely to re-emerge in the run-up to the 14th party congress, now expected in fall 1992. That congress will elect a party leadership for a new five-year term. It will also select a new slate of state leaders, to be ratified at the spring 1993 legislative session, that will probably include replacements for President Yang Shangkun, Vice President Wang Zhen, and legislative head Wan Li, and possibly the "promotion" to a less powerful and visible position of the unpopular premier, Li Peng. The death of octogenarians Deng, Yang, or Chen Yun---or of leaders in their 60s and 70s--could precipitate a round of leadership infighting even sooner. (CClarke) (CONFIDENTIAL)

II. CHINA: ECONOMIC REFORM BACK ON THE AGENDA--CAUTIOUSLY  
(4/25/)

Economic reform--slowed, but never stopped or reversed after Tiananmen--is back on the leadership's agenda.

China's recent economic austerity program reduced the inflation rate from double digits to about 2% in 1990 but precipitated rising unemployment and enterprise losses. Escalation of claims on the government nearly doubled the budget deficit. Under strong economic and political pressure,

Beijing leaders early this year endorsed a resumption and acceleration of reforms that slowed or stalled after Tiananmen.

Over the past two years the government has raised prices for energy, transport, and many intermediate goods and raw materials, and devalued the yuan by about 30%. Rises in retail prices for grain on May 1 will be only partly offset by increased urban-income subsidies. According to the World Bank, the state now fixes prices on only about one-fourth of all commodities; another 25% fluctuate within state-set limits. Prices for half of all commodities are market determined, a proportion Premier Li Peng recently said he expects to increase.

#### Markets and ownership

The non-state sector has continued to grow, despite post-Tiananmen political tightening and the austerity program. Less than 40% of national income now originates in the state sector, whose growth continues to be outpaced by that of collectives, joint ventures with foreigners, and private enterprises. Premier Li recently called for a greater role for market forces, even within the state sector.

Beijing has cautiously resumed experimentation with shareholding, including state enterprises, most of whose "shares"--representing debt, not equity--can be bought only by other state firms or government agencies, though individual shareholding in collective firms is spreading rapidly. China now has two local stock markets--admittedly trading only a few stocks--and is studying allowing foreigners to purchase shares.

#### Finance

Beijing recently announced that 25% of this year's treasury bonds would be sold by an investment syndicate rather than levied as forced purchases by workers. Secondary bond markets now exist in 61 Chinese cities and are integrated by a national securities exchange that opened last year. This week Beijing lowered interest rates on savings, a step that will make bond purchases more attractive.

#### Welfare

Beijing has also endorsed local implementation of reforms in housing, unemployment insurance, pensions, and medical care that will spread the costs among state, enterprise, and beneficiary. These reforms will also open the door to creation of labor and housing markets and pave the way for possible wider implementation of existing bankruptcy legislation.

## Outlook

Beijing's newfound commitment to reform is circumscribed by a strong determination to preserve a leaner and more efficient core of centrally planned state industry. The leadership's commitment to reform is also tempered by an overriding concern for economic, political, and social stability. Signs that reforms are engendering renewed inflation or straining public tolerance--or leadership consensus--will almost certainly result in a slowdown or reassessment. (CClarke) (CONFIDENTIAL)

### III. PRC/US: DOWNWARD SPIRAL IN RELATIONS (4/26)

Beijing's expectations for US-China ties are increasingly pessimistic, though officials are maintaining a cooperative attitude and hoping that improved ties with others, especially Moscow, will prod the United States to follow suit. But the elders increasingly suspect a conspiracy to subvert the regime.

Complacency in Beijing that normal relations with the United States would gradually resume, in the wake of improvements with the EC and Japan and next month's Sino-Soviet summit, is being shaken.

[REDACTED]

#### Dark portrayals of US intent

PRC leaders, shocked by the unexpectedly rapid US victory in the Gulf war and by disorder in the USSR, have been dismayed by US international dominance. A "two track" policy

[REDACTED]

[REDACTED] is probably intended also to apply to US relations with China, and the reaction to the President's meeting with the Dalai Lama suggests fear that Washington may try to destabilize China's sensitive border regions. Leadership paranoia is also evident in the argument, formerly heard only from ideologues but now raised in the PRC press in Hong Kong and in academic journals, that US "new hegemonism" is attempting to create "hundreds of Americas" in the Third World.

#### Conspiracy

Party elders have always been suspicious of US intentions toward China, suspicions periodically sharpened by US involvement in issues of sovereignty such as Taiwan or Tibet or by US attempts to link such key issues as MFN with Chinese actions on human rights or arms sales. In the current Beijing

climate, few moderate think tank or government specialists are willing to risk censure by granting the United States any benefit of doubt or recommending FKC compromise. Even the brave are unlikely to gain a hearing from leaders now more prone to emotion than reason.

#### Outlook

We are beginning to see the traditional Chinese fall-back position--tough talk and manipulative foreign policy. Beijing's protests over the Dalai Lama's activities have resurrected buzz words typical of past periods of bilateral crisis: Beijing officials insist sovereignty "brooks no outside interference;" on linkage, they cite Deng Xiaoping's 1981 comment (on potential US advanced-aircraft sales to Taipei) that "we will swallow no bitter pills."

With Moscow, Beijing has placed growing cooperation in the context of forging an effective "socialist" counterweight to the United States; with the home audience, Beijing has exaggerated US "triangular" concerns over the Sino-Soviet summit. Chinese leaders have encouraged Japanese and European independence of the United States and seem to view warming Soviet-Japanese relations as a similarly positive step.

Beijing will probably continue to seek dialogue and accommodation on discrete US-China trouble spots while resisting linkage and bristling over issues related to sovereignty. Grudgingly, for instance, the Chinese have engaged the United States in a dialogue on human rights and Tibetan issues. But the elders may soon convince themselves that "accommodation" invites only more pressure.  
(CHamrin) (SECRET/NOFORN/NOCONTRACT/ORCON/EXDIS)

#### IV. CHINA/UK/HONG KONG: THE AIRPORT ISSUE, AND MORE (4/26)

Negotiations between the Chinese and British on a compromise over a proposed multi-billion-dollar airport have boiled down to one major point--Chinese control over Hong Kong affairs. China and Britain diverge widely over interpreting the joint 1984 declaration on Hong Kong that calls for consultations on issues that will affect Hong Kong after 1997. Since serious discussions on Hong Kong's future resumed late last year, China has said it must have a role in all important issues straddling 1997, and Britain has insisted it has sole authority until 1997. Recently, the British blinked.

Recent negotiations over the airport failed, but the British yielded on a point of principle in agreeing to earmark 14 billion Hong Kong dollars of government reserves to be

turned over, with interest, to the Hong Kong special autonomous region government that takes over in 1997. The Chinese yielded on a lesser point by reducing the amount they demanded be earmarked.

Smaller and cheaper is better

But the Chinese want more--a significantly scaled-back project using only private funding and the number-two position on the airport authority. In contrast to British insistence on confidentiality, the Chinese want public disclosure and debate, apparently believing they can win public support for their sketchy plan. Most important, the Chinese want the British to accept the principle of a Chinese right to a say in all important decisions straddling 1997.

Rather than yield on unacceptable Chinese interference in the running of Hong Kong, the British are threatening to shelve the airport project.

Why democracy now?

Before 1984, largely out of fear of uncertain PRC reaction, the British dampened the development of Hong Kong political activity and self rule. The joint declaration's promise of a return to Chinese rule in 1997 gave Hong Kong a window of opportunity to set up institutions maximizing local autonomy. The Chinese inadvertently encouraged this trend by enunciating the "one country two systems" theory and pledging to continue Hong Kong's capitalist institutions for 50 years beyond 1997.

Recently the British and the Hong Kong government have taken a series of steps designed to expand Hong Kong autonomy. They have proposed a bill of rights, for example, and an independent judiciary and expanded elections to the legislative council. In reaction, China is now asserting it better represents the interests of the people of Hong Kong in the run-up to 1997 than does the British Hong Kong government. China is using its leverage to block private investment in the airport to make the broader point that it wants a say in all major issues extending beyond 1997.

Principle or prosperity?

The Chinese and British are both taking what they believe are stands on principle at considerable potential cost to Hong Kong confidence. The British hope the Chinese will back down to save the Hong Kong "golden goose," from which Beijing can hope to profit even more after 1997. The Chinese believe time is on their side: no matter what is done between now and 1997, after that year there will be only one interpretation of Hong Kong rules--China's.

Even were the Chinese to yield on the airport or other issues, they have already shown they intend to exert control over Hong Kong affairs after 1997. (MFinegan) (CONFIDENTIAL)